

CHAPTER 5

REPORTING STANDARDS FOR FINANCIAL AUDITS

INTRODUCTION

5.1 This chapter presents reporting standards for financial audits, which include audits of financial statements and other work governed by the American Institute of Certified Public Accountants' (AICPA) generally accepted auditing standards and related Statements on Auditing Standards (SASs). Generally accepted government auditing standards (GAGAS) incorporate the AICPA field work and reporting standards and related SASs unless the Comptroller General of the United States excludes them by formal announcement.¹ This chapter identifies the AICPA generally accepted reporting standards and prescribes for financial audits conducted in accordance with GAGAS additional reporting standards on

- a.** reporting compliance with generally accepted government auditing standards (see paragraphs 5.3 through 5.6),
- b.** reporting on compliance with laws and regulations and on internal control over financial reporting (see paragraphs 5.7 through 5.10),
- c.** reporting deficiencies in internal control (see paragraphs 5.11 through 5.15),
- d.** reporting fraud, illegal acts, and other noncompliance (see paragraphs 5.16 through 5.26),
- e.** reporting views of responsible officials (see paragraph 5.27 through 5.31),

¹To date, the Comptroller General has not excluded any field work or reporting standards or statements on auditing standards.

- f. privileged and confidential information (see paragraphs 5.32 through 5.34), and
- g. report issuance and distribution. (See paragraphs 5.35 through 5.38).

5.2 The four AICPA generally accepted standards of reporting are as follows.

- a. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.**
- b. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.**
- c. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.**
- d. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.**

REPORTING COMPLIANCE WITH GENERALLY
ACCEPTED GOVERNMENT AUDITING STANDARDS

5.3 An additional reporting standard for financial audits conducted in accordance with GAGAS is:

Audit reports should state that the audit was made in accordance with generally accepted government auditing standards.

5.4 The above statement refers to all the applicable standards that the auditors should have followed during their audit. The statement referencing compliance with generally accepted government auditing standards should be qualified in situations where the auditors did not follow an applicable standard. In these situations, the auditors should disclose in the scope section of the report the applicable standard that was not followed, the reasons therefore, and how not following the standard affected, or could have affected, the results of the audit.

5.5 When the report on the financial audit is submitted to comply with a legal, regulatory, or contractual requirement for a GAGAS audit, it should specifically cite GAGAS. The report on the financial audit may cite AICPA standards as well as GAGAS.

5.6 An audited entity receiving a GAGAS audit report may also need a financial audit report for purposes other than to comply with requirements calling for a GAGAS audit. For example, the audited entity may need audited financial statements to issue bonds or for other financing purposes. When a GAGAS audit is the basis for an auditor's subsequent report under the AICPA standards, it would be advantageous to users of the subsequent report for the auditor's report to include the information on compliance with laws and regulations and internal control that is required by GAGAS but not required by AICPA standards. To reissue essentially the same report omitting the information regarding compliance with laws and regulations and internal control is not in the public interest.

REPORTING ON COMPLIANCE WITH LAWS AND
REGULATIONS AND ON INTERNAL CONTROL
OVER FINANCIAL REPORTING

5.7 An additional reporting standard for financial statement audits² conducted in accordance with GAGAS is:

When providing an opinion on financial statements, auditors should include in their report on the financial statements either a (1) description of the scope of the auditors' testing of compliance with laws and regulations and internal control over financial reporting and the results of those tests or an opinion, if sufficient work was performed; or (2) reference to the separate report(s) containing that information. In presenting the results of those tests, auditors should report fraud, illegal acts, other material noncompliance, and reportable conditions in internal control over financial reporting.

5.8 Auditors may report on compliance with laws and regulations and internal control over financial reporting in the report on the financial statements or in separate report(s). When auditors report on compliance and internal control over financial reporting as part of the report on the financial statements, auditors should include an introduction summarizing key findings in the audit of the financial statements and the related compliance and internal control work. Auditors should not issue this introduction as a stand-alone report.

5.9 When auditors report separately (including separate reports bound in the same document) on compliance with laws and regulations and internal control over financial reporting, the report on the financial statements should state that the auditors are issuing those additional reports. The report on the financial statements should also state that the reports on compliance with laws and regulations and internal control over financial reporting are an integral part of a GAGAS audit,

²Although the following standard on reporting on compliance with laws and regulations and on internal control over financial reporting is applicable to audits of financial statements, the requirement to report deficiencies in internal control (see paragraphs 5.11 through 5.15) and reporting fraud, illegal acts, and other noncompliance (see paragraphs 5.16 through 5.26) is applicable to all financial audits.

and, in considering the results of the audit, these reports should be read along with the auditors' report on the financial statements.

Scope of Compliance and Internal Control Work

5.10 Auditors should report the scope of their testing of compliance with laws and regulations and of internal control over financial reporting, including whether or not the tests they performed provided sufficient evidence to support an opinion on compliance with laws and regulations or internal control over financial reporting and whether the auditors are providing such opinions.³

REPORTING DEFICIENCIES IN INTERNAL CONTROL

5.11 The additional reporting standard for financial audits conducted in accordance with GAGAS is:

Auditors should report significant deficiencies in internal control considered to be reportable conditions as defined in AICPA standards.

5.12 The following are examples of matters that may be reportable conditions:⁴

- a.** absence of appropriate segregation of duties consistent with appropriate control objectives;
- b.** absence of appropriate reviews and approvals of transactions, accounting entries, or systems output;

³ Auditors should follow the AICPA's Statements on Standards for Attestation Engagements when providing opinions on internal control over compliance with laws and regulations or on internal control over financial reporting. See chapter 6 for a discussion of the attestation standards.

⁴ AICPA standards define reportable conditions as significant deficiencies in the design or operation of internal control which could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

- c. inadequate provisions for the safeguarding of assets;
- d. evidence of failure to safeguard assets from loss, damage, or misappropriation;
- e. evidence that a system fails to provide complete and accurate output consistent with the control objectives of the audited entity because of the misapplication of control activities;
- f. evidence of intentional override of internal control by those in authority to the detriment of the overall objectives of the system;
- g. evidence of failure to perform tasks that are part of internal control, such as reconciliations not prepared or not timely prepared;
- h. absence of a sufficient level of control consciousness within the organization;
- i. significant deficiencies in the design or operation of internal control that could result in violations of laws and regulations having a direct and material effect on the financial statements; and
- j. failure to follow up and correct previously identified deficiencies in internal control.

5.13 In reporting on deficiencies in internal control, auditors should identify those that are individually or in the aggregate considered to be material weaknesses.⁵ Auditors should place their findings in proper perspective by providing a description of the objectives, scope, and methodology used to conduct the work. To give the reader a basis for judging the prevalence and

⁵The AICPA standards define a material weakness as a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

consequences of these findings, the instances identified should be related to the population or the number of cases examined and be quantified in terms of dollar value, if appropriate. Auditors may include such information in their audit report or may prepare a separate report. If auditors report separately, the audit report should contain a reference to the separate report containing this information⁶ and state that the separate report is an integral part of the audit and should be considered in assessing the results of the audit.

5.14 To the extent possible, auditors should present findings to identify the elements of criteria, condition, and effect, as well as cause when problems are found. In addition, auditors should provide recommendations for corrective action if auditors are able to sufficiently develop the findings. However, the elements needed for a finding depend entirely on the scope and objectives of the financial audit, and, as a result, may not always have all of the elements fully developed. At a minimum, auditors should identify the condition, criteria, and possible effect to provide sufficient information to federal, state, and local officials to assist them in taking corrective action.

5.15 When auditors detect deficiencies in internal control that are not reportable conditions, they should communicate those deficiencies to officials of the audited entity, preferably in writing. If the auditors have communicated other deficiencies in internal control in a management letter to officials of the audited entity, auditors should refer to that management letter when they report on internal control. Auditors should include in their audit documentation evidence of all communications to officials of the audited entity about deficiencies in internal control.

REPORTING FRAUD, ILLEGAL ACTS, AND OTHER NONCOMPLIANCE

5.16 An additional reporting standard for financial audits conducted in accordance with GAGAS is:

⁶For audits of financial statements, such information is generally included in the reports on compliance and internal control over financial reporting.

Auditors should report fraud, illegal acts, or other material noncompliance. In some circumstances, auditors should report fraud and illegal acts directly to parties external to the audited entity.

5.17 AICPA standards and GAGAS require auditors to address the effect fraud or illegal acts may have on the audit report and to determine that the audit committee or others with equivalent authority and responsibility are adequately informed about the fraud or illegal acts. The additional GAGAS standard does not modify these responsibilities. However, AICPA standards do not require that this communication be written, nor do they address communication regarding other noncompliance (violations of other compliance requirements such as provisions of contracts or grant agreements).

5.18 When auditors conclude, on the basis of evidence obtained, that fraud or an illegal act either has occurred or is likely to have occurred,⁷ they should report the relevant information. Auditors need not report information about fraud or an illegal act that is clearly inconsequential. Thus, auditors should include in their report the same information about fraud and illegal acts that they have informed the audit committees about under AICPA standards. Auditors should also report other noncompliance that is material to the audit.

5.19 In reporting material fraud, illegal acts, or other noncompliance, the auditors should place their findings in proper perspective by providing a description of the objectives, scope, and methodology used to conduct the work. To give the reader a basis for judging the prevalence and consequences of these findings, the instances identified should be related to the population or the number of cases examined and be quantified in terms of dollar value, if appropriate. Auditors may include such information in their audit report or may prepare a separate report. If auditors report separately, the audit report should contain a reference to the separate report containing this

⁷Whether a particular act is, in fact, illegal may have to await final determination by a court of law or other adjudicative body. Thus, when auditors disclose matters that have led them to conclude that an illegal act is likely to have occurred, they should not imply that they have made a determination of illegality.

information⁸ and state that the report is an integral part of the audit and should be considered in assessing the results of the audit.

5.20 To the extent possible, auditors should present findings to identify the elements of criteria, condition, and effect, as well as cause when problems are found. In addition, auditors should provide recommendations for corrective action if auditors are able to sufficiently develop the findings. However, the elements needed for a finding depend entirely on the scope and objectives of the financial audit, and, as a result, may not always have all of the elements fully developed. At a minimum, auditors should identify the condition, criteria, and possible effect to provide sufficient information to federal, state, and local officials to assist them in taking corrective action. Auditors should also obtain the views of responsible officials of the audited entity regarding the findings and include this information in the report as appropriate.

5.21 When auditors detect fraud, illegal acts, or other noncompliance that do not meet criteria for reporting in paragraph 5.18, they should communicate those findings to officials of the audited entity, preferably in writing. If auditors have communicated those findings in a management letter to officials of the audited entity, auditors should refer to that management letter when they report on compliance. Auditors may provide less extensive disclosure of fraud and illegal acts that are not material in either a quantitative or qualitative sense.⁹ Auditors should include in their audit documentation evidence of all communications to officials of the audited entity about fraud, illegal acts, and other noncompliance.

Direct Reporting of Fraud and Illegal Acts

5.22 GAGAS require auditors to report fraud or illegal acts directly to parties outside the audited entity in two circumstances, as discussed below. These requirements are in addition to any legal

⁸For audits of financial statements, such information is generally included in the reports on compliance with laws and regulations and internal control over financial reporting.

⁹Paragraphs 4.26 and 4.27 provide guidance on factors that may influence auditors' materiality judgments in audits of government entities or entities receiving government assistance. AICPA standards provide guidance on the interaction of quantitative and qualitative considerations in materiality judgments.

requirements for direct reporting of fraud or illegal acts. Auditors should meet these requirements even if they have resigned or been dismissed from the audit.¹⁰

5.23 Officials of the audited entity may be required by law or regulation to report certain fraud or illegal acts to specified external parties, such as a federal inspector general or a state attorney general. If auditors have communicated such fraud or illegal acts to officials of the audited entity and they fail to report them, then the auditors should communicate such an awareness to the governing body of the audited entity. If the officials of the audited entity do not make the required report as soon as practicable after the auditors' communication with the entity's governing body, then the auditors should report the fraud or illegal acts directly to the external party specified in the law or regulation.

5.24 Management of the audited entity is responsible for taking timely and appropriate steps to remedy fraud or illegal acts that auditors report to it. When fraud or an illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statements or resign from the audit, then they should communicate that conclusion to the governing body of the audited entity. Then, if officials of the audited entity do not report the fraud or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the fraud or illegal act directly to that entity.

5.25 In both of these situations, auditors should obtain sufficient, competent, and relevant evidence, such as confirmation with outside parties, to corroborate assertions by management that it has reported fraud or illegal acts. If they are unable to do so, then the auditors should report the fraud or illegal acts directly as discussed above.

5.26 Under some circumstances, laws, regulations, or policies may require auditors to report promptly indications of certain types of fraud or illegal acts to law enforcement or investigatory

¹⁰Internal audit organizations do not have a duty to report outside that entity unless required by law, rule, regulation, or policy.

authorities. When auditors conclude that this type of fraud or illegal act either has occurred or is likely to have occurred, they should ask those authorities and/or legal counsel if reporting certain information about that fraud or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

VIEWS OF RESPONSIBLE OFFICIALS

5.27 An additional reporting standard for financial audits performed in accordance with GAGAS is:

If the auditors' report discloses significant deficiencies, auditors should report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as corrections planned.

5.28 One of the most effective ways to ensure that a report is fair, complete, and objective is to obtain advance review and comments by responsible officials of the audited entity and others, as may be appropriate. Including the views of responsible officials produces a report that shows not only what was found and what the auditors think about it but also what the responsible persons think about it and what they plan to do about it.

5.29 Auditors should normally request that the responsible officials' views on significant findings, conclusions, and recommendations be submitted in writing. Oral comments are acceptable as well, and, in some cases, may be the only or most expeditious way to obtain comments. Cases in which obtaining oral comments can be effective include when there is a time-critical need to meet a user's needs; the auditor has worked closely with the responsible officials throughout the conduct of the work and the parties are very familiar with the findings and issues addressed in the draft product; or the auditor does not expect major disagreements with the draft report's findings, conclusions, and recommendations, or perceive any major controversies with regard to the issues discussed in the draft report. Auditors should prepare a

summary of the officials' oral comments and provide a copy of the summary to management of the audited entity to verify that the comments are accurately stated.

5.30 Comments should be fairly and objectively evaluated and recognized, as appropriate, in the final report. Comments, such as a promise or plan for corrective action, should be noted but should not be accepted as justification for dropping a significant finding or a related recommendation.

5.31 When the comments oppose the report's findings, conclusions, or recommendations, and are not, in the auditors' opinion, valid, the auditors should state their reasons for disagreeing with the comments. The auditors' disagreement should be stated in a fair and objective manner. Conversely, the auditors should modify their report as necessary if they find the comments valid. Auditors may wish to attach the comment letter to the audit report to provide the reader with both points of view.

PRIVILEGED AND CONFIDENTIAL INFORMATION

5.32 An additional reporting standard for financial audits conducted in accordance with GAGAS is:

If certain pertinent information is prohibited from general disclosure, the audit report should state the nature of the information omitted and the requirement that makes the omission necessary.

5.33 Certain information may be prohibited from general disclosure by federal, state, or local laws or regulations. Such information may be provided on a need-to-know basis in a separate limited official-use report which is restricted to only persons authorized by law or regulation to

receive it. The auditors should, when appropriate, consult with legal counsel regarding any requirements or other circumstances that may necessitate the omission of certain information.

5.34 Additional circumstances associated with public safety and security concerns could also justify the exclusion of certain information in the report. For example, information related to computer security for a particular program should be excluded from publicly available reports because of the potential damage that could be caused by the misuse of this information. In such circumstances, auditors may issue a limited official-use report containing such information and distribute the report only to those parties responsible for acting on the auditors' recommendations. If auditors make the judgment that certain additional information should be excluded from a publicly available report, they should state the nature of the information omitted and the reasons that makes the omission necessary.

REPORT ISSUANCE AND DISTRIBUTION

5.35 An additional reporting standard for financial audits conducted in accordance with GAGAS is:

Auditors should submit written audit reports to the appropriate officials of the audited entity and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations such as legislative bodies, unless legal restrictions prevent it. Auditors should also send copies of the reports to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless the report is restricted by law or regulation, or contains privileged and confidential information, auditors should ensure that copies be made available for public inspection.

5.36 Audit reports should be distributed in a timely manner to officials interested in the results.¹¹ Such officials include those designated by law or regulation to receive such reports, those responsible for acting on the findings and recommendations, those of other levels of government that have provided assistance to the audited entity, and legislators. However, if the subject of the audit involves material that is classified for security purposes or not releasable to particular parties or the public for other valid reasons, auditors may limit the report distribution.

5.37 When public accountants are engaged, the engaging organization should ensure that the report is distributed appropriately. If the public accountants are to make the distribution, the engagement agreement should indicate which officials or organizations should receive the report.

5.38 Internal auditors should follow their entity's own arrangements and statutory requirements for distribution. Usually, they report to their entity's top managers, who are responsible for distribution of the report. Further distribution of reports outside the organization should be made in accordance with applicable laws, rules, regulations, or policy.

¹¹See the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133 on single audits for the distribution of reports on single audits of state and local governmental entities and nonprofit organizations that receive federal awards.